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In the Supreme Court of the United States

OCTOBER TERM, 1947

No. 380

ANNE P. HUMPHREY, ESTATE OF ALBERT PATTERSON HUMPHREY, DECEASED, JOE A. HUMPHREY, INDEPENDENT EXECUTOR, IRENE HUMPHREY, LAYTON HUMPHREY AND JOE A. HUMPHREY, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 115–142) is not officially reported. The opinion of the Circuit Court of Appeals (R. 223–226)[1] is reported at 162 F. 2d 1.

[1] The opinion appearing at these pages of the record is the unanimous opinion of the court below on the issue with respect to which the writ of certiorari is sought. In addition, there was a dissenting opinion in the court below (R. 226–228) on another issue, not involved in the present application for certiorari.

JURISDICTION

The judgment of the Circuit Court of Appeals (R. 228–229) was entered on July 2, 1947. The petition for a writ of certiorari was filed on October 1, 1947. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the recovery in the taxable year of an amount taken as a bad debt deduction in a prior year with tax benefit resulted in ordinary income taxable in full under Section 22 (a) of the Internal Revenue Code, or whether it may be treated as a capital gain, taxable at capital gain rates under Section 117 of the Code.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set out in the Appendix, *infra,* pp. 11–17.

STATEMENT

In the present application, certiorari is sought only with respect to one of the issues in controversy before the Tax Court (R. 122–124, 138–140), and before the court below (R. 223–225), namely, as to whether the amount of $47,431.04 realized by the Joe A. Humphrey Company partnership in the taxable year 1941, upon notes with respect to which a bad debt deduction had been taken in

a prior year, constituted ordinary income—rather than capital gain—includible pro rata in the taxable income of the partners and their respective spouses, the petitioners herein (Pet. 1–2, 8; R. 118–119).

The facts with respect to that issue, as found by the Tax Court (R. 122–124), may be summarized as follows:

On January 1, 1941, the partnership, the Joe A. Humphrey Company, held notes executed by the Ellis Petroleum Company in the aggregate face amount of $63,758.25. Its entire investment in those notes, amounting to $42,200, had been charged off by it in 1939 as worthless and uncollectible, with a resulting tax benefit. (R. 122.)

On December 15, 1939, a court proceeding was filed for the reorganization of the Ellis Petroleum Company, and the partnership filed therein a proof of its claim for the indebtedness of $63,758.25, which proof of claim was allowed and adjudged to constitute a second lien on the property of the bankrupt, inferior only to administrative expenses and court costs and the lien of a bank, and to be of equal dignity and on a parity with the lien securing a claim of McClanahan & Venable, whose claim was allowed in the amount of $45,725.16 (R. 122–123).

On September 5, 1941, the referee in bankruptcy ordered the sale at public auction of certain property of the bankrupt. At the sale, on October

15, 1941, the property was bid in by the Humphrey partnership and McClanahan & Venable, jointly, for a final bid price of $160,000. The sale was subsequently confirmed, and the bidders (in addition to making certain cash payments with respect to the superior lien of the bank, not here material) were allowed as a credit towards the purchase price the sum of $79,051.73 on account of their notes and liens for that amount. On December 3, 1941, the property was conveyed to Joe A. Humphrey to the extent of 60 percent, and to McClanahan & Venable to the extent of 40 percent. The face amount of notes of Ellis Petroleum Company in the total amount of $79,051.73 which were collected in this transaction were allocable $47,431.04 to the Humphrey partnership and $31,620.69 to McClanahan & Venable. (R. 123–124.)

The notes in question had been held by the Humphrey partnership for more than 24 months (R. 124).

The Commissioner has included in the respective gross incomes of the petitioners for the year 1941 their pro rata share of the $47,431.04[2] credit

[2] In his determination (R. 27, 48, 66, 85, 104–105), the Commissioner had taken as the amount includible in the gross income of the partnership and of the petitioners the sum of $63,758.25—which sum represents the aggregate face amount of Ellis Petroleum Company notes held by the partnership (R. 122). However, before the Tax Court (R. 138), he conceded that the amount includible in gross income with

given the partnership in connection with the purchase of the Ellis Petroleum Company properties on account of the notes written off and allowed as a deduction in a prior year, with tax benefit (R. 27, 48, 66, 85, 104–105).

In the Tax Court, the petitioners, conceding that the transaction resulted in income to the partnership in the amount of $47,431.04, claimed only that the $47,431.04 constituted capital gain, instead of ordinary income (R. 117, 138). The Tax Court, sustaining the Commissioner, held that the amount in question was taxable as ordinary income (R. 138–140).

The court below affirmed the decision of the Tax Court on this issue (R. 223–225).

ARGUMENT

The court below correctly affirmed the decision of the Tax Court upholding the Commissioner's position that the $47,431.04 credit received by the partnership in the taxable year with respect to the notes constituted ordinary income, taxable pro rata to the petitioners. The partnership's entire cost of $42,200 for all of the notes had been charged off and deducted in 1939, with tax benefit. In 1941, it realized $47,431.04 by reason of the application of notes of a face value in that

respect to the notes was only $47,431.04—which amount represents the partnership's portion of the total amount of notes allowed as a credit towards the purchase price of the property at the sale (R. 124).

amount towards the purchase price of the property, which must be regarded as being worth not less than the bid amount. (R. 140, 224–225.) The $47,431.04 was admittedly taxable income, as conceded before the Tax Court (R. 138) and before the court below (R. 224). In this Court (Pet. 14, Br. 20), the only question raised is whether, instead of being taxable in full as ordinary income, it may be treated as capital gain, taxable at capital gain rates.

1. The Tax Court upheld the taxation of the amount as ordinary income upon the theory that, to the extent of the amount of $42,200 previously charged off and deducted as a bad debt in 1939,[3] the result of the transaction in 1941 constituted the recovery of an amount previously deducted as a bad debt with tax benefit and was therefore to be treated as ordinary income. The amount of a recovery during the taxable year on account of a bad debt deduction taken in a prior year must be included in gross income in the year of recovery, under Treasury Regulations 103, Sections 19.23 (k)–1 and 19.42–1 (Appendix, *infra*, pp. 16–17).[4]

[3] The treatment of the remaining $5,231.04 is discussed *infra*, pp. 9–10.

[4] Provisions with respect to the recovery of bad debts similar to those contained in Sections 19.23 (k)–1 and 19.42–1 of Regulations 103 have appeared, respectively, as far back as in Article 151 of Regulations 65, promulgated under the Revenue Act of 1924, and in Article 51 of Regulations 62, promulgated under the Revenue Act of 1921.

Such recovery has repeatedly and consistently been held to be includible in gross income as ordinary income and not as capital gain; the propriety of such treatment follows from the fact, pointed out by the Tax Court (R. 139), that the charge-off of the debt in the prior year constitutes an offset to ordinary income. See *Putnam National Bank* v. *Commissioner,* 20 B. T. A. 45, affirmed, 50 F. 2d 158 (C. C. A. 5th). See also *National Bank of Commerce of Seattle* v. *Commissioner,* 40 B. T. A. 72, affirmed on another point, 115 F. 2d 875 (C. C. A. 9th), and *Central Loan & Investment Co.* v. *Commissioner,* 39 B. T. A. 981. Inclusion in gross income in the taxable year of the bad debt previously charged off and deducted with tax benefit is in keeping with Section 22 (b) (12) of the Internal Revenue Code, as amended retroactively by the Revenue Act of 1942 (Appendix, *infra,* pp. 11–13), which permits the exclusion from gross income only of bad debt recoveries with respect to which there has been no deduction with tax benefit in a prior year. For the Committee reports on this provision seem to assume that the amount which is not excludible from gross income under that amendment—namely, the amount of the bad debt recovery as to which there had been a deduction with tax benefit in a prior year—must be includible in gross income as ordinary income. See H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 69–71 (1942–2

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Cum. Bull. 372, 426–427), and S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 79–80 (1942–2 Cum. Bull. 504, 565–566). Under the circumstances, the Tax Court properly approved the taxation as ordinary income of the partnership's "recovery" on the notes in the taxable year to the extent of $42,200, for which there had been a deduction with tax benefit in a prior year, and the court below correctly affirmed that decision.

There is no merit to the petitioners' contention (Pet. 13–15, 21–24) that this decision of the court below ignores the provisions of Section 19.23 (k)–3 of Treasury Regulations 103 (Appendix, *infra*, pp. 16–17) and is in conflict with *Nichols* v. *Commissioner*, 141 F. 2d 870 (C. C. A. 6th), and *Hadley Falls Trust Co.* v. *United States*, 110 F. 2d 887 (C. C. A. 1st). Briefly, Section 19.23 (k)–3 of the Regulations provides that if the mortgaged property is bought at the sale by the mortgagee, the mortgagee may have a bad debt deduction for the excess of the mortgage indebtedness (up to his cost) over the bid price, and, in addition, he realizes gain or loss in the amount of the difference between the amount of the mortgage obligations applied to the bid price and the fair market value of the property, which is presumed to be the bid price in the absence of proof to the contrary.[5] In the instant case, the property

[5] For an illustration of the manner of computing the mortgagee's bad debt and gain or loss, see I. T. 3159, 1938–1 Cum. Bull. 188.

was worth the bid price (R. 140, 224–225), upon the basis of which the partnership income taxable to the petitioners has been computed; this fact makes it obvious that the decision below does not ignore the provisions of the Regulations insofar as the determination of *the amount* of the mortgagee's income is concerned. The fact that the property in this case was worth the bid price is also a complete answer to the claim that the decision below is in conflict with *Nichols* v. *Commissioner, supra,* or *Hadley Falls Trust Co.* v. *United States, supra,* which held that the fair market value of the property (and not the bid price) is controlling in determining the mortgage creditor's income. See *Malden Trust Co.* v. *Commissioner,* 110 F. 2d 751 (C. C. A. 1st). With respect to *the character* of the mortgagee's income, namely, whether capital gain or ordinary income, this provision of the Regulations is inapplicable in this case and lends no support to the petitioners' claim that the income constituted capital gain, because, as already pointed out, the taxing as ordinary income of the $47,431.04 realized by the partnership on the notes in the taxable year is justified and proper to the extent of $42,200 as the recovery of a bad debt.

2. As to the difference ($5,231.04) between the $42,200 previously charged off and the $47,431.04 credit received on the notes in the taxable year, the Tax Court upheld its inclusion in income as ordinary income upon the theory that such dif-

ference could be interest, as contended by the Commissioner upon the authority of *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, although recognizing that if facts sufficient to establish it had been shown, the difference might be treated as capital gain (R. 139–140). Upon the record, the decision of the Tax Court upon this phase of the case is likewise correct and was properly affirmed by the court below, which stated that it could not say (R. 225)—

> that the $5,431 realized beyond the $42,200 agreed original investment in them all is other than ordinary gain, perhaps interest which the notes earned on their true consideration. * * *

CONCLUSION

The decision below is correct. It turns upon the particular facts of the case and presents no question calling for review by this Court. There is no conflict of decisions. The petition should, therefore, be denied.

Respectfully submitted.

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OCTOBER, 1947.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) [As amended by Section 116 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] [6] *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(12) *Recovery of bad debts, prior taxes, and delinquency amounts.*—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such

[6] Subsection 12, which was added to Section 22 (b) of the Internal Revenue Code by Section 116 (a) of the Revenue Act of 1942, was made applicable by Section 116 (b) of the 1942 Act with respect to taxable years beginning after December 31, 1938.

debt, tax, or amount. For the purposes of this paragraph:

(A) *Definition of Bad Debt.*—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(B) *Definition of Prior Tax.*—The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(C) *Definition of Delinquency Amount.*—The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(D) *Definition of Recovery Exclusion.*—The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

(E) *Special Rules in Case of Section 102 Tax and Personal Holding Company Tax.*—In the application of subparagraphs

(A), (B), (C), and (D) in determining the tax under section 102 or Subchapter A of Chapter 2, a recovery exclusion allowed for the purposes of Chapter 1 shall be allowed for the purpose of such section or subchapter whether or not the bad debt, prior tax, or delinquency amount resulted in a reduction of the section 102 tax or Subchapter A tax for the prior taxable year; and in the case of a bad debt, prior tax, or delinquency amount not allowable as a deduction or credit for the prior taxable year under Chapter 1 (except section 102) but allowable for the same taxable year under such section or subchapter a recovery exclusion shall be allowable for the purposes of such section or subchapter if such bad debt, prior tax, or delinquency amount did not result in a reduction of the tax under such section 102 or such Subchapter A. As used in this subparagraph references to Chapter 1, section 102, and Subchapter A in the case of taxable years not subject to the Internal Revenue Code, shall be held to be made to corresponding provisions of prior revenue Acts.

(26 U. S. C. 1940 ed., Sec. 22.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the

ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l);

* * * * *

(b) *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

(26 U. S. C. 1940 ed., Sec. 117.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (b) (12)–1 [as amended by T. D. 5288, 1943 Cum. Bull. 103]. *Recovery of Bad Debts, Prior Taxes, and Delinquency Amounts.*—(*a*) *In general.*—Section 22 (b) (12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. In substance, the recovery exclusion is an amount equal to the portion of such items which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer

under Chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

(1) *Section 22 (b) (12) items.*—Bad debts, prior taxes, and delinquency amounts are defined in section 22 (b) (12) (A), (B), and (C), respectively. A typical example of a delinquency amount described in that section is interest upon delinquent taxes. The bad debts, prior taxes, and delinquency amounts referred to in that section, called "section 22 (b) (12) items" in this section, are only those for which a deduction or credit was allowed for a prior taxable year. Thus, if a bad debt was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 22 (b) (12) item.

(2) *Definition of "recovery."*—Recoveries result from the receipt of amounts in respect of the previously deducted or credited items described in section 22 (b) (12), such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. Care should be taken in the case of bad debts which were treated as only partially worthless in prior years to distinguish between the item described in section 22 (b) (12), that is, the part of such debt which was deducted, and the part not previously deducted, which is not a section 22 (b) (12) item and is considered the first part collected. The collection of the part not deducted is not considered a "recovery." Furthermore, the term "recovery" does not

include the gain resulting from the receipt of an amount on account of a section 22 (b) (12) item which, together with previous such receipts, exceeds the deduction or credit previously allowed for such item. For instance, a $100 corporate bond purchased for $40 and later deducted as worthless is subsequently collected to the extent of $50. The $10 gain (excess of $50 collection over $40 cost) is not a recovery of a section 22 (b) (12) item. Such gain is in no case excluded from gross income under section 22 (b) (12), regardless of whether the $40 recovery is or is not excluded.

* * * * *

SEC. 19.23 (k)–1. *Bad debts.*—(a) Bad debts may be treated in either of two ways—

(1) By a deduction from income in respect of debts ascertained to be worthless in whole or in part, or

* * * * *

(b) If all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. * * *

* * * * *

SEC. 19.23 (k)–3. *Uncollectible deficiency upon sale of mortgaged or pledged property.*—If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the mortgagee or pledgee ascertains that the portion of the

indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off, he may deduct such amount (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it is ascertained to be wholly or partially worthless and charged off. In addition, if the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

* * * * *

SEC. 19.42–1. *When included in gross income.*—* * * Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. (See section 19.23 (k)–1.)

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